

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B04

PLR-127398-08

Date:

November 24, 2008

In Re:

Legend

Settlor	=
Trust	=
Daughter	=
<u>X</u>	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
<u>A</u>	=
<u>B</u>	=
<u>x</u>	=
<u>y</u>	=
Trustees	=
Trust A	=
Trust B	=
Court	=

State =
Statute
State =
 =

Dear :

This is in response to a letter dated October 29, 2008, and prior correspondence from your authorized representatives, requesting rulings on the income and generation-skipping transfer (GST) tax consequences of the proposed division and modification of a trust.

Facts

On Date 1, Settlor established an irrevocable trust for the benefit of Daughter, spouse and issue, spouses of issue, Daughter's siblings and their spouses and issue, and spouses of those issue. On Date 2, Settlor established a second identical trust (Trust) for Daughter. Date 1 and Date 2 are dates prior to September 25, 1985. It is represented that no additions have been made to Trust subsequent to that date. In Year 3, under State statute, the Date 1 trust was merged into Trust. Trustees received a private letter ruling from the Internal Revenue Service that the merger of the two trusts will not give rise to a constructive addition to Trust and would not cause the Trust to lose its GST exempt status.

Under the terms of Trust, Trustees, shall collect all income and pay the net income in convenient installments, in such proportions and with such exclusions as the Trustees deem advisable to any of the beneficiaries of Trust. Trustees also have the right and are authorized to accumulate any or all of such income and add it to the principal of Trust. If the payment of income is insufficient to any individual beneficiary, Trustees are authorized to use so much of the principal as they deem necessary to defray expenses of any illness, accident or other emergency, or to provide for the proper maintenance, support and education of such beneficiary. Trust is to terminate twenty-one years after the last to die of the four children of Settlor living at the date of Trust agreement. Trustees may terminate Trust whenever they deem it to be in the best interest of the beneficiaries or for any other reason advisable to do so. Upon termination, Trustees are to transfer the trust property to Daughter, if living, if Daughter is not living, then to her issue per stirpes. Failing such then living issue, the trust property is to be divided equally among the three trusts for Settlor's other children.

In Year 1, Trustees filed a declaratory judgment action with Court, seeking to disclaim their discretionary power under Trust to distribute property to organizations described in § 170(c) (governmental entities). This was necessary because Trust could not qualify as an ESBT if such organizations were potential current beneficiaries of

Trust. Trustees received a private letter ruling from the Internal Revenue Service that the renunciation and release of the Trustees' power to make distributions to governmental entities would not constitute a constructive addition to Trust and Trust would not lose its GST exempt status.

Trust is a shareholder of X, a company incorporated in State. In Year 2, the shareholders of X elected to treat X as an S corporation effective Date 3, in Year 2. On Date 3, Trustees filed an election to treat Trust as an electing small business trust (ESBT). Subsequent to making this election, in Year 4, A, a resident alien, married B, a potential current beneficiary of Trust. As of Year 4, there were y potential current beneficiaries and x additional current income beneficiaries. All of the living potential current beneficiaries, other than A, are United States citizens. Even though A is a resident alien, A may receive income or principal distributions at Trustees' discretion. Because A may, in the future, become a nonresident alien, disqualifying Trust as an ESBT, Trustees intend to divide Trust into two separate trusts, Trust A and Trust B, with identical beneficiaries. On Date 4, pursuant to Court order, Trustees were authorized to divide Trust into Trust A and Trust B. Trust A will hold X stock. Trust B will hold the other assets of Trust.

After the modification, the trust agreement of Trust A will provide that the Trustees have the authority to relinquish their ability to make discretionary distributions of income and principal from Trust A to any non-resident alien, as described in § 7701(b)(1)(B) of the Code, or any successor statute, who may otherwise be a beneficiary of the trust for so long as (1) the trust shall have in effect an election to be taxed as an ESBT pursuant to § 1361(e), or any successor statute, and (2) a non-resident alien is not permitted to be a potential current income beneficiary of an ESBT under applicable provisions of the Internal Revenue Code or Treasury Regulations. After the modification, both trusts will have identical beneficiaries and terms, except that Trustees of Trust A will be prohibited from making distributions to non-resident alien beneficiaries. All the living beneficiaries who are of majority age have consented to the petition and the proposed division of Trust. The Court order is conditioned on receiving a private letter ruling.

Pursuant to State Statute, a court, for cause shown, may authorize the division of a trust into two separate trusts upon such terms and conditions and with notice as the court shall direct.

You have requested the following rulings:

1. The proposed division of Trust into Trust A and Trust B, in accordance with Court's order: (i) will not cause a beneficial interest to be shifted to a beneficiary who occupies a generation lower than the beneficiaries who hold the interests prior to the division; and (ii) will not extend the time for vesting of any beneficial interest in Trust A or Trust B beyond the period provided for currently in the Trust.

2. The proposed division of Trust into Trust A and Trust B, in accordance with the Court's order authorizing division of Trust and modification of Trust A to prohibit distributions to nonresident alien beneficiaries as long as nonresident aliens are not permissible current beneficiaries of an ESBT or as long as Trust A holds S corporation stock, will result in Trust A being eligible to elect to be an ESBT under § 1361(e)(1).

ISSUE 1

Section 2601 of the Internal Revenue Code imposes a tax on each generation-skipping transfer. Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 Act and § 26.2601-1(b)(1)(I) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in § 26.2601-1(b)(1)(ii)(B) or (C) (relating to property includible in the grantor's gross estate under §§ 2038 and 2042).

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, but only if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Trust was irrevocable prior to September 25, 1985, and it is represented that there have been no additions (constructive or otherwise) to Trust after September 25, 1985. Accordingly, Trust is exempt from the generation-skipping transfer tax.

Based on the facts presented and representations made, we conclude that the proposed division of Trust will not shift any beneficial interest in Trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the proposed division of Trust will not extend the time for vesting of any beneficial interest in Trust 1 or Trust 2 beyond the period provided for in the original trust.

ISSUE 2

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(c)(2)(A)(v) provides that, for purposes of § 1361(b)(1)(B), an ESBT may be a shareholder of an S corporation.

Section 1361(e) defines an ESBT. Section 1361(e)(2) provides that, for purposes of § 1361(e), the term "potential current beneficiary" (PCB) means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.

Section 1361(c)(2)(B)(v) provides that in the case of an ESBT, each PCB of such trust shall be treated as a shareholder for purposes of § 1361(b)(1); except that, if for any period there is no PCB of such trust, such trust shall be treated as the shareholder during such period.

Section 1.1361-1(m)(4)(i) of the Income Tax Regulations provides that for purposes of determining whether a corporation is a small business corporation within the meaning of § 1361(b)(1), each PCB of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of § 1.1361-1(m)(4), a PCB generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust.

Section 1.1361-1(m)(1)(ii)(D) provides that a nonresident alien (as defined in § 7701(b)(1)(B)) is an eligible beneficiary of an ESBT. However, if the nonresident alien is a PCB of the ESBT the S corporation will have an ineligible shareholder and its S corporation election will terminate.

Section 1.1361-1(m)(5)(iii) provides that if a PCB of an ESBT is not an eligible shareholder of a small business corporation within the meaning of § 1361(b)(1), the S corporation election terminates. For example, the S corporation election will terminate if a nonresident alien becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date.

Pursuant to § 1.1361-1(m)(4)(iv), a person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

Based solely on the facts and representations submitted, we conclude that the proposed division of Trust into Trust A and Trust B, in accordance with Court's order authorizing the division of Trust and modification of Trust A to prohibit distributions to nonresident alien beneficiaries as long as nonresident aliens are not permissible current beneficiaries of an ESBT or as long as Trust A stock, will result in Trust A being eligible to elect ESBT status under § 1361(e)(1).

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is otherwise eligible to be treated as an S corporation or whether Trust is otherwise eligible to be an ESBT.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures

Copy for § 6110 purposes

cc: